AD-A095 083 RAND CORP SANTA MONICA CA F/G 5/5
USER CHARGES, CONTRACTING OUT, AND PRIVATIZATION IN AN ERA OF F--ETC(U)
APR 80 A H PASCAL
UNCLASSIFIED RAND/P-6471 NL

1 OF 1
A
095083

END
DATE
FILMED
8-81
DTIC

USER CHARGES, CONTRACTING OUT, AND PRIVATIZATION
IN AN ERA OF FISCAL RETRENCHMENT

Anthony H. Pascal

April 1980

P-6471

BACKGROUND

We are fast approaching an era of fiscal limits in the United States. The government's share of Gross National Product has already begun to fall from its 1975 peak, at which time it accounted for about 35 percent of GNP. (The government's share was only 23 percent in 1949.) (See Pascal et al., 1979, p. 12.) The rate of growth in government spending in constant dollars was, in the period 1975-79, only 2.4 percent, as compared to a rate of 5.5 percent in 1949-75. (See Pascal and Menchik, 1979, p. 2.)

There are many sources of fiscal containment. The tax revolt has led to the adoption of fiscal limitations which have already cut back or capped the growth of local and state revenues in half of all U.S. states (Pascal et al., 1979, pp. 57-78). Propositions 13 and 9 in California are merely the most prominent of the measures. The movement is rapidly accelerating and is spreading across the country, although it is most prominent in the West (Pascal and Menchik, 1979, pp. 6-8). In addition, taxpayers are decreasingly likely to vote yes in tax override and bond elections and are turning more and more to fiscally conservative candidates for office. The real value of federal grants to states and localities has been declining; the threat to end general revenue sharing suggests an imminent decline in nominal values. State surpluses are shrinking rapidly, thus limiting the ability of states to support local governments. Households and business firms are departing the high taxing states of the North East, for the lower taxing Sunbelt, while continuing suburbanization also shifts taxpayers to lower taxing jurisdictions. (In general, on these points, see Pascal and Menchik, 1980.)

Many factors help explain the containment of government. The rapid post-war rise in tax burdens, the shift in government spending away from universalistic and toward redistributive programs, rapid inflation combined with stagnant real incomes, and rising distrust of politicians and governmental institutions have all contributed.

In California where the cutback in tax collections has been the stiffest, the search is on for devices which will both raise additional revenues and make the government more efficient. Market-

oriented mechanisms, such as user charges, contracting out and privatization are all being tried. As retrenchment comes to pass in other parts of the nation, such devices are bound to gain in popularity.

HOW DO MARKET-ORIENTED MECHANISMS WORK?

User charges, contracting out and privatization have in common the use of private incentives to improve the efficiency with which public services are produced or consumed. Requiring the public to pay directly for services promises to reduce waste in consumption (i.e., in theory consumers will purchase increments to the point where marginal gains to them equal additional costs); injecting competition into the production of services will drive down costs (i.e., inter-firm rivalry will replace monopolistic government production). Yet each of the mechanisms has its own strengths and weaknesses which justifies separate discussion. (A useful review of the issues is provided in Savas, 1974.)

User Charges

Quoting the U.S. Bureau of the Census, Stocker (1974, p. 398) writes "User charges are amounts received from the public for performance of specific services benefiting the person charged." Thus, an important criterion which ought to govern the employment of user charges is the ability to identify benefits and beneficiaries (see ACIR 1974, pp. 63-77). If the benefits are not visible to and largely appropriable by the potential consumer of the services, few will volunteer to pay. Trash collection then is highly amenable to financing through user charges while traffic control is not.*

*All true public goods have spillover benefits. In the case of trash collection, for example, these would involve neighborhood sanitation and amenity. In general, the higher the externalities and the less the appropriability by the direct consumer, the less amenable is the service for financing and delivery by means of user charges. (For the general theory of user charges and a review of the pre-1972 literature for this topic, see Milliman, 1972.)

A second criterion is based on the prospect for economizing behavior in the use of public resources. Services in which consumption levels are sensitive to price differentials are also good candidates for the application of user charges. From this perspective parking fees may be more appropriate than sewer service charges. Ease of administration and the effects of user charge financing on the distribution of income constitute additional selection criteria (see ACIR, 1974, pp. 63-66). Obstacles to the extension of the user charge mechanism lie in the difficulty cities have in calculating price elasticities, marginal costs, and the distribution of benefits (Stocker, 1976, p. 320).

Opportunities for the establishment of user charges at the local government level occur in water distribution, education, hospitals, solid and liquid waste disposal, fire protection, parking and road usage, recreation, and for licenses and permits. User charges can often be imposed for specific components of services which in general have a high public good content. For example, crowd control at public events or special patrols at shopping centers may be financed through user charges, while other more general aspects of police protection are financed through taxes. (See Mushkin and Bird, 1972, pp. 24-25.)

Contracting Out

The term contracting out refers to the purchase of inputs by government from private sources in the process of producing a public service financed by tax collections. The purchase typically encompasses only a component part of the whole of the service delivered to the public. Some cities contract for tree trimming in public parks or for forensic laboratory examinations in producing, respectively, recreation and police services for their residents. Scottsdale, Arizona, on the other hand, receives its fire services from a private, profit-making company.

Competition for city business, for which bids are often taken is responsible for the lower cost of contracted services. Minneapolis has 50 companies competing for trash collection contracts; Wichita

has 80. The cost savings can be substantial. In the early 1970s in the borough of Queens, New York, publicly provided sanitation cost $207 per household per year, while three miles away in Bellrose, Long Island, the private costs for the same service were $72 (U.S. News, 1975).* Savas (1974, p. 109) alleges that street resurfacing under municipal auspices cost $57 per ton of asphalt laid, while private contractors did the same job for $20 in New York City.

In discussing the Scottsdale experience, Ahlbrandt (1974) writes:

> ...competitive supply results in lower average costs of production than supply by [local government]. Perhaps, however, the most significant long run benefits are with respect to research and development, the adoption of new technology, and the satisfaction of consumer preferences. (p. 355)

Scottsdale's Rural Metropolitan Fire Protection Company, for example, makes substantial use of light trucks (as compared to the heavy engines typical of municipal fire departments) and has adopted innovative deployment strategies (U.S. News, 1975). Other services appropriate for contracting out include emergency ambulances, building security, street cleaning, snow removal, and school lunches.

None of this is to argue that contracted services are inevitably a better value for taxpayers. In the late 1960s a series of demonstrations occurred which involved performance contracting in education in which private firms undertook for a fee to teach reading to disadvantaged school children. Writing about this experience, Carpenter and Hall (1971, pp. vi-vii) concluded: "The performance contracts did not produce dramatic gains on standardized achievement tests" while the instructional costs were about equal to those in typical Title I programs run by public school teachers.

---

*Some observers have argued that the main advantage of private contractors lies not in superior production techniques but in their ability to escape paying union wages to their employees. Increasingly, public employees are members of strong and militant bargaining organizations.

Privatization

Privatization occurs when a governmental body turns over the supply of a public service to private providers. The new suppliers are compensated directly by consumers. Thus privatization differs from the user charge mechanism because in the former, non-governmental organizations produce and distribute the service. It differs from contracting out in that the entire service, not merely an input, is provided by private sources and because consumers, not taxpayers, compensate the supplier. But the best candidate services for privatization are probably those in which user charges can carry the entire financial load. (Savas, 1974, p. 103.)

Two forms of privatization have been identified. (Pascal et al., 1979, p. 85.) In the first case vouchers are issued by the government to consumers, which they turn over to the providers on the receipt of the services. Subsequently, the governmental body redeems the vouchers and compensates providers monetarily. Vouchers have been used, in one form or another, for higher education (as under the G.I. Bill), for day care, and for vocational training. Food stamps, housing allowances, and Medicare are forms of the voucher arrangement. Attempts to use vouchers in public schooling have been precluded as a result of determined opposition by organized teachers (as in the emasculation of NIE's planned experiments in the early 1970s) or by the lack of interest on the part of voters (e.g., the failure of the Coons/Sugarman initiative to qualify for the California ballot).

A second form of privatization occurs when the government fails to provide a service traditionally part of the package of public goods. In some jurisdictions, trash collection has always been in private hands, although the government may induce purchase of the service by means of police power applied in the interest of public sanitation. Summer schooling in California became largely privatized after the passage of Proposition 13 in 1978. Most of the state's school districts stopped providing summer classes to most students; voluntary sector groups, such as the YM/WCA and private firms, stepped into the breach, meanwhile collecting fees from users in exchange for the service.

TRENDS IN THE USE OF MARKET-ORIENTED MECHANISMS

The employment of user charges by local government has been growing steadily, if not dramatically, since 1960, as evidenced in Table 1. Over this period non-taxes--which are mostly fees and charges--grew from 12 to 15 percent of locally collected revenues.

Cities that receive abnormally large revenues from charges are typically those that have a municipal university, city hospital or a municipal airport, and city-operated sewerage systems and solid waste disposal (Stocker, 1976, pp. 319-320). Overall, about half of all local user charges are generated by health and education activities (Stocker, 1974, p. 403).

Generally, the larger the city, the less is the dependence on financing through fees and charges (Mushkin and Bird, 1972, pp. 9-11). From a geographic standpoint, local governments in the Pacific and Mountain states are most prone to user charges; the New England and Middle Atlantic states have the lowest propensity; the Southern and Mid Western states lie between these extremes (Stocker, 1974, p. 402).

Table 1

LOCAL GOVERNMENT REVENUES 1960-75

	Year			
	1960	1965	1970	1975
Total Receipts ($Billion)	31.2	47.0	84.1	144.7
Percent of all revenues from:				
Property tax	50	48	42	35
Other taxes	10	9	10	11
Grants from federal government	2	3	4	10
Grants from state government	30	32	36	36
Non-taxes*	8	8	8	8
Percent of all locally collected revenues from:				
Property tax	73	74	70	65
Other taxes	15	14	17	20
Non-taxes*	12	12	13	15

SOURCE: Levin, 1978, pp. 15-21.

*Includes an undetermined but presumably small amount of local taxes on business other than sales and property taxes.

In the aftermath of Proposition 13, many California cities adopted or extended user charges. They were applied to museum and recreation facility admissions, building permits, fire inspections, dog licenses and emergency ambulance services (see Pascal et al., 1979, p. 87). According to the report of California's Legislative Analyst (1979) California cities increased collections of service charges by 11 percent between fiscal years 1977 and 1978, while total revenues increased 3 percent. In the last year before Proposition 13, charges accounted for 11 percent of own source revenues; in the first year after they accounted for 15 percent. Additional fiscal controls, such as Proposition 9 on the June 1980 ballot, which will halve the state's income tax rates, may spur additional extensions of charge-financing in California. But California officials may encounter the same sort of resistance to extension found elsewhere. Stocker (1974, pp. 416-418) reports a survey of 66 municipal finance officials which concluded that political opposition among residents constituted the single greatest obstacle to the utilization of this mechanism.

Contracting out is a device known to be widely employed in local government but no systematic data on magnitudes and trends are available. As part of an ongoing study, a Rand Corporation team queried a substantial sample of law enforcement and criminal justice officials in California to ascertain whether contracting had become more prevalent after the passage of Proposition 13. Little evidence for growth in the use of this mechanism was forthcoming. However, it was reported, Proposition 9 will substantially reduce grants from the state to local government and may induce more contracting to the extent it promises to reduce government costs.

In a poll of 52 city managers in California, Sonnenblum et al. (1975, p. 29) discovered that a shift to private contractors was expected for service "characterized by well developed technologies, more easily measured outputs, low political saliency, and availability of private firms as producers...[such as] in refuse collection, tree trimming and street cleaning." The strongest opposition to contracting out comes from public employee unions. (Sonneblum, pp. 31-32, and *National Journal*, 1977, pp. 1411-13.)

Good data on the extent and spread of privatization are similarly lacking. Although the school voucher movement appears to have been stopped in its tracks, Ballabon (1972) discussed the growing interest in what he calls "self-service groups [who] despite their eligibility for access to public services prefer and select private alternatives . . . Traditionally drawn from upper and middle income classes, self-service groups are emerging among the poor and underprivileged, partially supported by public funds." He cites examples in schooling, libraries, recreation, hospitals, transport and personal and property protection (pp. 33-34).

IMPLICATIONS OF THE EXTENDED USE OF MARKET-ORIENTED MECHANISMS

From the foregoing, it would be fair to conclude that the market-oriented mechanisms will find increasing favor, although there are factors which may inhibit extension. The ACIR report (1974, pp. 66-68) points to the nondeductability of charges on state and federal income taxes, to the fact that charges are not counted as part of the revenue base in federal and state grant formulas, and to various state laws which constrain their use. Despite the disappointing experience with performance contracting in education it also seems safe to conclude that the use of the market-oriented mechanisms promises significant efficiencies in government operations. (In general on this theme see Savas, 1974; Paul, 1972; and Vickery, 1972.) A less frequently explored dimension has to do with equity consequences. If user charges, contracting out and privatization find new applications, who will lose and who will gain?

The employment of user charges and the decision of government to shed its load by abandoning services to the private sector both have serious implications for equity in the finance and distribution of public goods. The changes will occasion a shift in the financing burden of the original package of public services toward lower income groups. The subsidies to the poor inherent in an approach financed by progressive forms of taxation--particularly to the extent that property and individual income taxes are used--will disappear as each consumer begins to pay the full costs of services used. Lower income

groups will find themselves devoting a higher fraction of income toward the consumption of heretofore free services than will the more affluent. The net result will be a move in the regressive direction.

Certain devices can lessen the regressivity of the market-oriented reforms. Instead of simply abandoning a particular service, for example, the government could decide to continue to support consumption through vouchers while allowing non-governmental organizations to actually provide the services, as discussed above. The benefits of competition would be maintained while the interests of lower income groups are preserved. Such a solution of course does not work directly to reduce government budgets except to the extent that private provision reduces overall costs.

Other devices also promise to relieve inequities. Charges imposed can be graduated according to the income of the using household, at some increase in administrative costs. Or a basic level of service could be provided free of charge while increments would require a payment from households. (In general, on this topic, see Wilcox and Mushkin, 1972.)

Privatization and contracting out are sometimes attacked on the grounds that a shift from public to private provision means the replacement of the civil service by big business. In reality, however, the employees of the contract-securing private organizations are likely to be more modestly compensated than the civil servants they supplant. Differential employee costs in fact constitute a chief explanation of the cost reductions promised by competitive provision. The result will be more job opportunities for lower paid workers and fewer for the higher paid, which is certainly not inequitable, however anti-union it may appear.

A switch to private provision of public goods may however threaten to reverse affirmative action gains. The public sector has in the last 15 years been considerably more hospitable to minorities, employing in many large cities twice the fraction of such workers as does the general economy (see Pascal and Menchik, 1980). Although equal opportunity regulations may serve to protect the jobs of minorities (and women) already on public payrolls, new opportunities could be severely squeezed, with resultant deleterious effects on oncoming cohorts of minority

workers. On the other hand, it should be possible to require appropriate equal opportunity policies among private service providers as a pre-condition to bidding on government contracts or accepting vouchers.

CONCLUSIONS

The fiscal limitation movement, aggravated by other trends in local and intergovernmental finance, appears to be hastening an era of fiscal retrenchment. Local government will search for ways to reduce government costs and to raise revenues not subject to fiscal controls. User charges, contracting out and privatization are obvious remedies. The advantages of these market-oriented mechanisms on the efficiency front, however, must be balanced against the inequities they may create. Certain adjustments in the application of the mechanisms can reduce the adverse distributional consequences.

REFERENCES

Advisory Commission on Intergovernmental Relations, *Local Revenue Diversification: Income Taxes, Sales Taxes and User Charges* (Report A-47), Washington, D.C., 1974.

Ahlbrandt, R. S., Jr., "Implications of Contracting for a Public Service," *Urban Affairs Quarterly*, March 1974, pp. 337-359.

Ballabon, M. B., "The Self-Service Group in the Urban Economy," *Journal of the American Institute of Planners*, January 1972, pp. 33-42.

Carpenter, P., and G. R. Hall, *Case Studies in Educational Performance Contracting: Conclusions and Implications*, The Rand Corporation, R-900/1-HEW, December 1971.

Legislative Analyst, "An Analysis of the Effect of Proposition 13 on Local Governments," State of California, October 1979.

Levin, D. J., "Receipts and Expenditures of State and Local Governments, 1959-76," *Survey of Current Business*, May 1978, pp. 15-21.

Millman, J. M., "Beneficiary Charges--Toward a Unified Theory," in S. J. Mushkin (ed.) *Public Prices for Public Products*, The Urban Institute, Washington, D.C., 1972, pp. 27-51.

Mushkin, S. J., and R. M. Bird, "Public Prices: An Overview," in S. J. Mushkin (ed.) *Public Prices for Public Products*, The Urban Institute, Washington, D.C., 1972, pp. 3-25.

Pascal, A. H., M. Menchik, J. M. Chaiken, P. L. Ellickson, W. E. Walker, D. N. DeTray, and A. E. Wise, *Fiscal Containment of Local and State Government*, The Rand Corporation, R-2494-FF/RC, September 1979.

Pascal, A. H., and M. Menchik, *Fiscal Containment: Who Gains? Who Loses?*, The Rand Corporation, R-2494/1-FF/RC, September 1979.

----, *Restraints on Taxing and Spending: Trends, Portents, Consequences*, The Rand Corporation, P-6469, April 1980.

Paul, E. S., "Pricing Rules and Efficiency," in S. J. Mushkin (ed.) *Public Prices for Public Products*, The Urban Institute, Washington, D.C., 1972, pp. 73-93.

Savas, E. S., "Municipal Monopolies vs. Competition in Delivering Urban Services" *Urban Analysis*, Vol. 2, 1974, pp. 93-116.

Sonenblum, S., et al., "Selecting Structures for Providing Municipal Services" (#198) Institute of Government and Public Affairs, University of California, Los Angeles (mimeo), 1975.

Stocker, F. D., "User Charges: Their Role in Local Government Finance," *Proceedings of the 67th Annual Conference, National Tax Association*, Tax Institute of America, 1974.

----, "Diversification of the Local Revenue System: Income and Sales Taxes, User Chargers, Federal Grants," *National Tax Journal*, September 1976, pp. 312-321.

Vickery, W. S., "Economic Efficiency and Pricing," in J. S. Mushkin (ed.) *Public Prices for Public Products*, The Urban Institute, Washington, D.C., 1972, pp. 53-71.

"Ways Private Firms Can Save Money for Burdened Cities," (Interview with John Diebold), *U. S. News and World Report*, 79:82, Nov. 17, 1975.

"When the Government Lets Somebody Else Do Its Job," *National Journal*, October 10, 1977, pp. 1410-1414.

Wilcox, M. C., and S. J. Mushkin, "Public Pricing and Family Income: Problems of Eligibility Standards," in J. S. Mushkin (ed.) *Public Prices for Public Products*, The Urban Institute, Washington, D.C., 1972, pp. 395-404.

DATE
ILMED
-8